WHY DEFICITS MATTER:
THE INTERNATIONAL DIMENSION

Hearings Before the
Budget Committee of the
House of Representatives

C. Fred Bergsten
Edwin M. Truman
Peterson Institute for International Economics

January 23, 2007

The Issue

Foreigners account for about $2.2 trillion, or a little over half, of the outstanding total of $4.3 trillion of US Treasury securities held by the public. Official institutions, mainly central banks, account for about 60 percent of this total. In addition, foreigners as a whole probably hold close to $1 trillion, or about 15 percent, of US government agency securities. The data are in Tables 1-4, prepared by our colleague Doug Dowson at our Peterson Institute for International Economics.

These totals and ratios have risen rapidly over the past twenty years. From 1985 to 2005, foreigners acquired almost 75 percent of the overall increase in outstanding Treasuries. From 1995 to 2005, domestic holdings actually fell while foreign holdings grew by twice the aggregate increase. Since 2001, foreign purchases of Treasuries have accounted for most of the rise in the total outstanding[1].

[1] Estimates of these longer trends are presented in Philip D. Winters, "Growth in Foreign Holdings of US Debt," Congressional Research Service, November 13, 2006.

These data raise the obvious question of whether the United States in general, and the US Government in particular, have become excessively dependent on foreigners to finance our domestic economy and indeed our federal budget. The ultimate concern is whether these holders, or perhaps some subset of them such as foreign governmental institutions, might precipitate a financial crisis by rapidly selling off large amounts of Treasuries for economic or even political reasons.

Foreign Holdings of Treasuries

The answer to these questions is two-fold. First, we do not need to worry very much about foreign holdings of US Treasury securities per se. The US capital markets are so large and so liquid, and the Treasury market is a sufficiently modest component of it, that foreign shifts from Treasuries to other dollar investments could readily be accommodated by a reallocation of the portfolios of other investors. We should worry even less about the risk of liquidation of Treasuries by foreign official institutions, including the largest holders in Japan and China, who are the least likely sources of disruption of our financial markets in view of their responsibilities for financial stability and their institutional aversion to being blamed for any disruption of the world economy – and, unfortunately, due to the desire of many of these countries to maintain undervalued exchange rates to bolster even further their international competitiveness.[2]

[2] One possible caveat is that rumors of sizable liquidations by foreign official holders could spook the markets and trigger a run on the dollar. Such rumors concerning Kuwait were in fact widely cited as a factor in the sharp fall of the dollar in late 1978, the closest the United States has ever come to experiencing a "hard landing." Similar rumors in more recent periods, however, have been largely shrugged off by the markets.

It would in fact be a mistake to overemphasize the 50 percent share of foreign holders of US Treasuries. The reason is that Treasury long-term debt accounts for less than 10 percent of the total stock of outstanding long-term US securities (Table 3). The addition of USG agency securities, of which foreigners hold about 15 percent, leaves their holdings of all governmental paper at about 20 percent of the overall capital market. Hence there is plenty of room for reallocation of investment portfolios by different groups of investors among different asset classes. If foreigners decided to shift their holdings of Treasuries to US agencies or corporate bonds (or bank deposits or some other assets), as they in fact seem to be doing (at least from short-term Treasury bills) in recent years, other investors would be attracted by the reduction in prices of Treasuries to make switches in the opposite direction. There might be some alteration in the relative prices of the different US assets, with a modest increase in the cost of financing the federal debt, but major disruptions would be highly unlikely.

When seen in this larger context of the entire US capital market, foreign holdings are more on the order of 15 percent. This is considerably less than their share of 50 percent in the Treasury market by itself. Foreigners hold only about 10 percent of US equities and about 20 percent of corporate bonds.

This conclusion receives strong empirical support from the experience of the last few years. Foreign holdings of Treasuries fell in 2000-01 but the exchange rate of the dollar continued to rise throughout that period. Conversely, foreign holdings of Treasuries rose sharply in 2003-04 while the dollar was declining steadily and substantially. There is simply no clear relationship between changes in foreign holdings of Treasuries and the value of our currency. [3]

Total Foreign Capital Flows to the United States

Second, however, we do need to worry considerably about total foreign holdings of dollar assets and, in particular, the extent to which our economy has become dependent on new capital inflows to finance both our external and internal deficits because those inflows could slow abruptly or even totally dry up at virtually any time. Because of the direct impact of the federal budget position on total national saving, and thus on our current account imbalance with the rest of the world, I believe that this US dependence on foreign funding is one of the major reasons we should adopt a national policy objective of restoring the modest federal budget surpluses that were in place as recently as 1998-2001.

At the margin, the role of foreigners in financing the US economy is much more salient than suggested by the averages cited above: they accounted for virtually the entire increase in the total holdings of all US long-term securities, including equities and corporate bonds, from 2000 to June 2005 (the latest date for which comprehensive data are available, see Table 3). It is true that this period is distorted by the sharp fall in equity prices after early 2000 and our ratio of dependence on foreign investors is considerably lower – though still close to 50 percent – if different base periods are chosen. But the United States has clearly become reliant on external funding for a very large proportion

[3] On this issue see especially Edwin M. Truman and Anna Wong, *The Case for An International Reserve Diversification Standard,* Working Paper 06-2, Washington, Institute for International Economics, May 2006.

of the investment needed to fuel our domestic economy and we need to carefully consider the implications thereof in setting national economic policy.

These financial flows are a manifestation of the very large and rapidly growing deficits in the US merchandise trade and current account balances with the rest of the world. Those deficits hit $850-875 billion in 2006, about 7 percent of GDP. They have increased by an average of $100 billion annually over the past four years (and by an annual average of over $80 billion for the past nine years). Funding those deficits requires the United States to attract $3-4 billion of foreign money (including direct investment as well as financial capital) every working day. As a result, our net foreign debt had climbed to $2.7 billion at the end of 2005. In addition, the United States exports capital (including direct investment as well as portfolio capital) in the range of $500 billion to $1 trillion every year, which must also be offset by capital inflows.[4]

Hence we must attract $7-8 billion of foreign capital every working day to avoid significant changes in prices, mainly of interest rates and exchange rates but also of equities and housing, throughout the US economy. Any substantial diminution of the total inflow of new foreign investment into the United States from this required total would have jarring effects on our financial markets and thus on our economy. The exchange rate of the dollar would fall, interest rates would rise, equity prices would almost certainly decline and the weakening of the housing market would be exacerbated. The scale of these shocks would depend largely on whether the reduction in foreign

[4] This large US capital outflow reminds us that Americans, at least as much as foreigners, could trigger a run on the dollar that would have the consequences described later.

inflows took place quickly, producing a "hard landing," or more gradually over a period of several years (as actually occurred in 2002-03 and again, albeit sporadically, in 2004 and 2006). With the US economy now at full employment, however, unlike in 2002-03 when considerable slack existed as we recovered from the recession of 2001, a rapid and sizable fall of the dollar could generate substantial inflationary pressure and push US interest rates up sharply, perhaps even into double digits, possibly triggering a severe recession.[5]

It would not matter whether the reduced inflow took place via the market for Treasury securities or for other asset classes. Nor would it matter whether the reduction came from foreign official institutions or, much more likely, private investors. What would count, perhaps severely, would be the cutback (or, in the extreme case, the drying up or reversal) of total foreign demand for additional dollar assets. The huge inflows of foreign capital in recent years have held down US interest rates and supported our economic expansion, thus obviating for a time the "crowding out" of private investment and growth that would otherwise have occurred as a result of the large budget deficits, but they have done so at considerable long-term cost to the economy (in terms of future debt service payments to foreigners) and with substantial ongoing risk to our stability and prosperity.

Thus it would not require a liquidation of foreign holdings of Treasuries, or any other class of dollar financial assets, to cause considerable problems for the US economy. Such liquidations, from the current total of such holdings of more than $10 trillion, would

---

[5] Martin Neil Baily, "Persistent Dollar Swings and the US Economy," in C. Fred Bergsten and John Williamson, eds., *Dollar Overvaluation and the World Economy,* Washington, Institute for International Economics, February 2003.

obviously make the situation worse. But we have become so dependent on <u>additional</u> inflows of very large amounts of foreign funds that any significant setback therein would have substantial consequences for our economy.

Some observers believe that the United States has not yet reached the point where there is serious risk of a large falloff in new foreign investment in the dollar.[6] It is true that the ratio of US foreign debt to GDP is only about 20 percent, which is modest by historical standards. But it is also true that we are on an unsustainable trajectory: my colleague Michael Mussa, the former chief economist of the IMF for ten years and a member of the Council of Economic Advisers under President Reagan, notes that continuation of the external deficits at current levels, let alone any further increases, would carry that ratio to at least 50 percent within the next few years and ultimately to 100-120 percent. This would be exceedingly dangerous terrain for an advanced industrial country, let alone the supposed steward of the world's key currency.[7]

Some observers also downplay the risk of any significant falloff in new foreign investments in the dollar on the grounds that "there is no place else to put the money." That view has proved repeatedly to be wrong in the past as indicated by the sharp falls in the dollar that have occurred about once per decade over the last 35 years, notably by more than 20 percent in 1971-73, about the same amount in 1978-79, more than 30 per

[6] See Richard N. Cooper, "Living with Global Imbalances: A Contrarian View," Washington, Institute for International Economics, November 2005.

[7] See Michael Mussa in "Sustaining Global Growth While Reducing External Imbalances," in C. Fred Bergsten and the Institute for International Economics, *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, Washington, January 2005. See also William R. Cline, *The United States as a Debtor Nation*, Washington, Institute for International Economics, September 2005.

cent (and about 50 percent against the DM and yen) in 1985-87 and (to its record lows) in 1994-95.

Currently and in the future, however, that view is even more incorrect because of the systemic change represented by the creation of the euro. The dollar was the world's dominant currency for most of the past century for a simple reason: it had no real competition. No other currency was based on an economy that was anywhere near the size of the United States nor was able to support financial markets of the breadth, depth and resiliency of ours. The euro, however, is based on an economy that is almost as large and that in fact features considerably larger levels of international trade and monetary reserves. Hence it presents, for the first time, a true alternative to the dollar and an alternative locus for footloose international investment that might previously have come into dollar assets.[8]

Indeed, euro-denominated bonds have attracted more international investment than dollar-denominated bonds for the past two years. The US financial market (at $48 trillion) is still considerably larger than the financial market of the Eurozone ($27 trillion) but now accounts for only one third of the global total and the Eurozone market is growing twice as fast. The periodic diversifications by foreign central banks of their reserve holdings out of dollars are primarily into euros and reflect this new international financial reality (though all these shifts have been handled in a way that avoids market

[8] See C. Fred Bergsten, "The Euro and the Dollar: Toward a 'Finance G-2'?" in Adam S. Posen, editor, *The Euro at Five: Ready for a Global Role?* Washington, Institute for International Economics, April 2005, especially pp. 30-35.

disruption, supporting the conclusion suggested above that foreign official institutions are highly unlikely to destabilize markets).[9]

The Policy Response

The only effective response to this potentially severe threat to US economic stability and prosperity is to substantially reduce the external deficit in our trade and current account balances.[10] The goal should be to cut that deficit at least in half, to about 3-3 ½ percent of GDP (at which level external funding might well be sustainable) rather than the 7 percent or so at present.

This will require a series of changes in economic policy in the United States and other major countries. One essential part of the package is to reduce the gap between saving and investment in the United States by a like amount of 3-4 percent of GDP, most or all of which should be accomplished by increasing national saving since reducing investment would weaken both our growth prospects and continued improvements in US productivity. The chief policy tool that we can deploy with some confidence to promote achievement of this objective is a shift in the budget position of the federal government over the next several years from today's deficits of 2- 3 percent of GDP to modest surpluses à la 1998-2001.[11]

---

[9] See Truman and Wong, *The Case for an International Reserve Diversification Standard,* Working Paper 06-2, Washington, Institute for International Economics, May 2006.

[10] These imbalances also add substantially to the difficulties of maintaining an open trade policy in the United States. See C. Fred Bergsten, "A New Foreign Economic Policy for the United States," in C. Fred Bergsten and the Institute for International Economics, *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, Washington, Institute for International Economics, January 2005.

[11] Detailed scenarios for doing so can be found in Cline, *The United States as a Debtor Nation,* Chapter 4, and Mussa, "Sustaining Global Growth While Reducing External Imbalances," especially pp. 193-196. It

It must be noted that there is no automatic link between the US budget and current account deficits. The external imbalance in fact soared anew during the late 1990s while the budget was moving into surplus (because domestic investment was running at postwar highs and continuing declines in private saving offset much of the reduction in public dissaving). In theory, there could be some offset to increases in public saving achieved by budget improvement via reduced private saving (though the two have tended to move in similar rather than opposite directions in the United States in recent decades).

The deficits were much more closely related throughout most of the 1980s, however, when both reached their previous record highs and required substantial adjustment. The external deficits would probably be much larger today had the budget not improved so dramatically during the 1990s. The tax cuts and rapid spending increases of the early years of this decade clearly worsened our external position, by further reducing national saving, and played central roles in pushing it to today's precarious levels. Indeed, less expansionary fiscal policy in recent years would have reduced the need for tightening of monetary policy by the Federal Reserve and produced a weaker dollar that would have strengthened our current account. Budget correction would almost surely promote external adjustment under current circumstances, perhaps by around one half of the improvement in the budget itself[12].

would of course be highly desirable to increase US private saving as well. This may happen spontaneously, at least to a limited extent, from the decline in the housing market and the rise in interest rates more generally but, unfortunately, there are no policy tools that can confidently be deployed to do so.

[12] There is a wide range of estimates of this relationship but they tend to cluster around 50 percent. The main outlier is the Federal Reserve, whose much lower estimates are explained and criticized in Cline, *The United States as a Debtor Nation.*

Trade policy is not the topic of this hearing but I would note, before closing, that the creation of new US barriers to imports of goods or capital would be an ineffectual and wholly inappropriate response to our trade and current account deficits. As indicated throughout my statement, these large imbalances are a macroeconomic problem that require macroeconomic (including exchange rate) remedies. It would be particularly counterproductive to discourage inflows of direct investment or any other forms of foreign capital, which we must continue to attract as long as we run current account deficits, as might well be the result of some of the current proposals for "reforming" the Committee on Foreign Investment in the United States (CFIUS) and US policy in that area more broadly.[13]

I believe there are strong reasons to convert the current, and especially prospective, US budget deficits into modest surpluses without appealing to these international aspects of the issue. But the vulnerability of the US economy to large and prolonged reductions in foreign capital inflows, especially if they occur abruptly, surely counsel that we "put our house in order" as promptly as possible. I am delighted that the Committee is assessing these issues as part of its deliberations on the fiscal situation and hope they will help persuade you to adopt an aggressive stance to sharply improve the prospects over the coming budget cycle.

[13] Edward M. Graham and David M. Marchick, *US National Security and Foreign Direct Investment*, Washington, Institute for International Economics, May 2006.